

State of California

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Legislative Change (Report) No. 98-05

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Laws Affecting Franchise Tax Board: Revenue and Taxation Code Sections:

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SUBJECT: Budget Trailer\Conformity Act of 1998

Assembly Bill 2797 (Machado), as enacted on, August 20, 1998, made the following changes to California law:

1.
Section **17024.5** of the Revenue and Taxation Code is amended.

Date change statute. (Internal revenue Code (IRC) § None) .

This Act changed the specified date from of January 1, 1997, to January 1, 1998.
By changing the date, the following federal law changes were conformed to:

a. Treatment of Cancellation of Certain Student Loans (IRC §108(f)).

The Tax Reform Act of 1997 (TRA of 1997) expanded the federal exclusion so that an individual's gross income does not include forgiveness of loans made by educational

Bureau Director

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Date

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organizations (and certain tax-exempt charitable organizations in the case of refinancing loans) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. As under present law, the exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, in the case of loans made by tax-exempt charitable organizations, the student's work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity. This provision applies to discharges of indebtedness occurring after August 5, 1997.

This Act conforms California law to the TRA of 1997 federal change to the forgiveness of student loans. This bill would not change the Forgivable Loan Program of the California State University system.

b. Repeal the Depreciation Adjustment for Alternative Minimum Tax (IRC §56(a)).

Under federal law, for property (including pollution control facilities) placed in service after December 31, 1998, the TRA of 1997 permits the recovery periods (but not the methods) used for purposes of alternative minimum tax (AMT) depreciation adjustment to be the same as the recovery periods used for purposes of regular tax. The recovery periods now allowed for AMT purposes are those allowed under the modified accelerated cost recovery system (MACRS).

This Act conforms California law to the TRA of 1997 federal change allowing the same depreciable lives used for regular tax purposes to be used for AMT purposes. This provision will be "chaptered" out if the Governor signs enrolled bill SB 2234.

c. Repeal of Throwback Rules for Domestic Trusts (IRC §§644, 645, 665 & 706).

The TRA of 1997 generally exempts from the throwback rules amounts distributed by a domestic trust after August 5, 1997. The throwback rule continues to apply with respect to (1) foreign trusts, (2) domestic trusts that were once treated as a foreign trust (except as provided in Treasury regulations), and (3) domestic trusts created before March 1, 1984, that are treated as multiple trusts under IRC section 643(f).

The TRA of 1997 also provides that precontribution gain on property sold by a domestic trust is no longer subject to IRC section 644 (i.e., taxed at the contributor's marginal tax rate.)

This Act conforms California law to the TRA of 1997 federal change as it relates to distributions from trusts.

d. Home Office Deduction: Clarification of Definition of Principal Place of Business (IRC §280A).

The TRA of 1997 amended section 280A to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is used by the

taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

As under prior law, deductions will be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer. Thus, under the TRA of 1997, a home office deduction is allowed (subject to the "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the TRA of 1997 will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second part of the test will be satisfied, regardless of whether the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law "convenience of the employer" test is satisfied. In cases where a taxpayer's use of a home office does not satisfy the provision's two-part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of IRC section 280A. This provision is effective for taxable years beginning after December 31, 1998.

This Act conforms California law to the TRA of 1997 federal changes made to the home office deduction. This provision would be operative for taxable years beginning after December 31, 1998.

e. Shrinkage Estimates for Inventory Accounting (IRC §471(b)).

The TRA of 1997 provided that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based

on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer is required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer is required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

It is anticipated that the Secretary of the Treasury will issue guidance establishing one or more safe harbor methods for the estimation of inventory shrinkage that will be deemed to result in a clear reflection of income, provided such safe harbor method is consistently applied and the taxpayer's inventory methods otherwise satisfy the clear reflection of income standard.

The safe harbor method should use a historical ratio based on the most recent three taxable years of shrinkage to sales, multiplied by total sales between the date of the last physical inventory and year-end. The historical ratio should be separately determined for each store or department in a store of the taxpayer and cannot be adjusted by judgmental or other factors (e.g., floors or caps). Estimated shrinkage determined in accordance with the consistent application of the safe harbor method will not be required to be recalculated, through a lookback adjustment or otherwise, to reflect the results of physical inventories taken after year-end. For a retailer that has not verified shrinkage by a physical inventory in each of the most recent three taxable years, the historical ratio is the average of the historical ratios of the retailer's other stores or departments. Retailers using last in, first out (LIFO) methods of inventory are expected to be required to allocate shrinkage among their various inventory pools in a reasonable and consistent manner.

This Act conforms California law to the TRA of 1997 federal change as it relates to the valuation of inventory.

f. Treatment of Worker's Compensation Liability under Rules for Certain Personal Injury Liability Assignments (IRC §130).

The TRA of 1997 extended the federal exclusion for qualified assignments under the IRC to amounts assigned for assuming a liability to pay compensation under any worker's compensation act. The TRA requires that the assignee assume the liability from a person who is a party to the worker's compensation claim, and requires that the periodic payment be excludable from the recipient's gross income under the IRC, in addition to the requirements of present law.

This Act conforms California law to federal law amended by the TRA of 1997 as it relates to the assignment and exclusion of worker's compensation claims.

g. Exclusion from UBIT for Certain Corporate Qualified Sponsorship Payments (IRC §513(i)).

Qualified sponsorship payments are excluded from "unrelated business income tax" (UBIT). The TRA of 1997 specifically provides that a qualified sponsorship payment does not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking

place or being broadcast, in and of itself, will not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, will be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus will not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

The TRA of 1997 provision does not apply to the sale of advertising or acknowledgments in tax-exempt organization periodicals. For this purpose, the term "periodical" means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. For example, the provision will not apply to payments that lead to acknowledgments in a monthly journal, but will apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event. The determination if a payment for a logo or a product line acknowledgment in an organization's periodical is subject to UBIT is made under law existing prior (and subsequent) to the passage of the TRA.

The TRA of 1997 provision specifically provides that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment will be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising and use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT will not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) in connection with a sponsorship payment will not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services will be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities will not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees (complimentary tickets, etc.) will be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise will be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income. The exemption provided by the provision will be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on).

This Act conforms California law to federal law amended by the TRA as it relates to the receipt of qualified sponsorship payments by exempt organization.

h. Increased Deduction for Business Meals for Individuals under Department of Transportation Limitations (IRC §274(n)).

The TRA of 1997 increased to 80% the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation. Individuals subject to the hours of service limitations of the Department of Transportation include:

- (1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
- (2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
- (3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and
- (4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

Taxable Years Beginning In	Deductible Percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

This Act conforms California law to the TRA of 1997 federal change as it relates to an increased percentage deduction for business meals for individuals subject to Department of Transportation limitations.

i. Deductibility of Meals Provided for the Convenience of the Employer (IRC §132(e)).

The TRA of 1997 provides that meals that are excludable from employees' incomes because they are provided for the convenience of the employer pursuant to IRC section 119 are excludable as a de minimis fringe benefit and therefore are fully deductible by the employer, provided they satisfy the relevant IRC section 132 requirements. No inference is intended as to whether such meals were fully deductible under prior law.

This Act conforms California law to the TRA of 1997 federal change as it relates to the deductibility of meals.

j. Modify Limits on Depreciation of Luxury Automobiles for Clean-Burning Fuel and Electric Vehicles (IRC §280(f)).

The TRA of 1997 modified the limitation on depreciation in the case of qualified clean-burning fuel vehicles and certain electric vehicles. Vehicles that are modified to permit such vehicle to be propelled by a clean-burning fuel, the TRA of 1997 applies the limitation to that portion of the vehicles' cost before modification. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel, without regard to the limitation.

In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the base-year limitation amounts of \$2,560 for the first taxable year in the recovery period, \$4,100 for the second taxable year in the recovery period, \$2,450 for the third taxable year in the recovery period, and \$1,475 for each succeeding taxable year in the recovery period are tripled to \$7,680, \$12,300, \$7,350, and \$4,425, respectively, and then adjusted for inflation after October 1997 by the automobile component of the Consumer Price Index.

This Act conforms California law to the TRA of 1997 federal change as it relates to the depreciation of clean-burning fuel and electric vehicles.

k. Suspension of Income Limitations on Percentage Depletion for Production from Marginal Wells (IRC §613A).

The TRA of 1997 suspended the 100% of net income property limitation for domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

This Act conforms California law to the TRA of 1997 federal change as it relates to temporary suspension of income limitations on percentage depletion for production from marginal wells.

l. Increase in Standard Mileage Rate for Purposes of Computing Charitable Deduction (IRC §170(i)).

The TRA of 1997 increased the mileage rate from 12 cents to 14 cents per mile.

This Act conforms California law to the TRA of 1997 federal change as it relates to the increase in the standard mileage rate for purposes of computing a charitable deduction.

m. Provide Above-the-Line Deduction for Certain Business Expenses (IRC §62(a)).

Under the TRA of 1997, employee business expenses relating to service as an official of a state or local government (or political subdivision thereof) are deductible in computing AGI (above the line), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for alternative minimum tax purposes.

This Act conforms California law to the TRA of 1997 federal change as it relates to employee business expenses of an official of a state or local government.

n. Required Recognition of Gain on Certain Appreciated Financial Positions
in Personal Property (IRC §1259).

The TRA of 1997 requires recognition of gain (but not loss) upon entering into a constructive sale of any "appreciated financial position" in stock, a partnership interest or debt other than certain "straight" debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of constructive sale. A constructive sale occurs when the taxpayer enters into one of the following transactions with respect to the same or substantially identical property: (1) a short sale, (2) an offsetting notional principal contract, or (3) a futures or forward contract. For a taxpayer who has one of these transactions, a constructive sale occurs when it acquires the related long position. Other transactions will be treated as constructive sales to the extent provided in Treasury regulations.

The TRA of 1997 provided an exception for certain short term hedges that would otherwise be treated as a constructive sale if all three conditions are met:

- the transaction is closed before the end of the 30th day after the close of the taxable year.
- the taxpayer holds the appreciated financial position.
- at no time during a 60-day period is the taxpayer's risk of loss reduced by holding certain other positions.

The TRA of 1997 also provided that the types of debt instruments excluded from the definition of "appreciated financial position" are instruments that are not convertible and the interest on which is either fixed, payable at certain variable rates, or based on certain interest payments on a pool of mortgages. In addition, the TRA of 1997 provided an exception for transactions closed during the 90-day period ending on the 30th day after the close of the taxable year and reestablished during such period, so long as the normal requirements for positions closed within such 90-day period are met by the reestablished position.

A trust instrument that is actively traded is generally treated as stock for purposes of determining whether the instrument is an appreciated financial position. The TRA of 1997 provided that a trust instrument will not be treated as stock if substantially all (by value) of the property held by the trust is debt that qualifies for the exception to the definition of appreciated financial position for certain debt instruments. In addition, only debt instruments that entitle the holder to receive an unconditional principal amount qualify for the exception.

The Joint Committee on Taxation's report clarifies some aspects of the application of the provision. Congress did not intend that an agreement that is not a contract for purposes of applicable contract law will be treated as a forward contract. Thus, contingencies to which the contract is subject will generally be taken into account. Congress intended that the constructive sale provision generally will apply to transactions that are identified hedging or straddle transactions under other code provisions. Where either position in such an identified transaction is an appreciated financial position and a constructive sale of such position results from the other position, the conferees intended that the constructive sale will be

treated as having occurred immediately before the identified transaction. The constructive sale will not, however, prevent qualification of the transaction as an identified hedging or straddle transaction. Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain will generally be recognized and accounted for under the relevant hedging or straddle provision. However, Congress intended that future Treasury regulations may except certain transactions from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision.

The Joint Committee on Taxation's report urges that the Treasury issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers.

This Act conforms California law to the TRA of 1997 federal change as it relates to recognition of gain on certain appreciated financial positions in personal property.

o. Limitation on Exception for Investment Companies under IRC Section 351(e).

The TRA of 1997 modified the definition of an investment company by requiring that the following assets also be taken into account for purposes of the 80% of control of the corporation test: money, financial instruments, foreign currency, and interests in RICs, REITs, common trust funds, publicly-traded partnerships and precious metals. The TRA of 1997 provides an exception for precious metals that are produced, used or held in an active trade or business. The TRA of 1997 also provides for "look through" rules for certain entities that hold the above-listed items. The TRA of 1997 also provides the Treasury with regulatory authority to remove items from the list in appropriate circumstances.

This Act conforms California law to the TRA of 1997 federal change as it relates to the definition of an investment company.

p. Gains and Losses from Certain Terminations with Respect to Property
(IRC §§1233, 1234A & 1271(b)).

The TRA of 1997 extended to all types of property that is a capital asset in the hands of the taxpayer the rule that treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation as a capital asset in the hands of the taxpayer as gain or loss from the sale of a capital asset.

The TRA of 1997 also repealed the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as sold or exchanged. Thus, gain or loss on the retirement of such debt will be capital gain or loss if the debt is a capital asset. The TRA of 1997 retains the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

In addition, the TRA of 1997 provided that if a taxpayer enters into a short sale of property and such property becomes substantially worthless, the taxpayer shall recognize gain as if the short sale were closed when the property becomes

substantially worthless. The TRA of 1997 also extends the statute of limitations with respect to such gain recognition to the earlier of: (1) three years after the Secretary of the Treasury is notified that the position has become substantially worthless; or (2) six years after the date of filing of the income tax return for the taxable year during which the position became substantially worthless. To the extent provided in Treasury regulations, similar gain recognition rules shall apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or with respect to any similar transaction or position that becomes substantially worthless.

No inference was intended as to the proper treatment of these or similar transactions or positions prior to the passage of the TRA of 1997.

This Act conforms California law to the TRA of 1997 federal change as it relates to gains and losses from certain terminations with respect to property.

q. Deny Interest Deduction on Certain Debt Instruments (IRC §163(c)).

Under TRA of 1997, no deduction is allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or certain related parties, including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party. In addition, an instrument is to be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

For example, it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt. The TRA of 1997 does not affect the treatment of a holder of an instrument. The TRA of 1997 is not intended to affect the characterization of instruments as debt or equity under present law.

This Act conforms California law to the TRA of 1997 federal change as it relates to the denial of interest deductions on certain debt instruments.

r. Require Gain Recognition for Certain Extraordinary Dividends (IRC §1059).

Under the TRA of 1997, except as provided in regulations, a corporate shareholder recognizes gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the non-taxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient

earnings and profits, the rule applies to the portion treated as a dividend. In addition, the TRA of 1997 requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under IRC section 356 are treated as redemptions for purposes of applying the rules relating to redemptions under IRC section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under IRC section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of IRC section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to IRC section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

The Treasury Department is authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of these provisions.

This Act conforms California law to the TRA of 1997 federal change as it relates to the tax treatment of certain extraordinary dividends.

s. Require Gain Recognition on Certain Distributions of Controlled Corporation Stock (Morris Trust Transaction) (IRC §§351, 355, 358 & 368).

The TRA of 1997 adopts additional restrictions on acquisitions and dispositions of the stock of a distributing or controlled corporation.

Under the TRA of 1997, if either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, gain is recognized as of the date of the distribution.

In the case of an acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. Such gain is recognized immediately before the distribution and is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain. The committee reports indicate that there is no intention to limit the otherwise applicable Treasury regulatory authority. There is also no intention to limit the otherwise applicable provisions of IRC section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

Whether a corporation is acquired is determined under rules similar to those of IRC section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly-owned subsidiary ("S") to its

shareholders in a transaction that otherwise qualifies as a IRC section 355 spin-off. If, pursuant to a plan or arrangement, 50% or more of the vote or value of either P or S is acquired by one or more persons, the TRA of 1997 requires gain recognition by the distributing corporation. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under IRC section 368(a)(1)(A), (C) or (D), the shareholders (immediately before the acquisition) of the corporation acquiring such assets are treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule.

Certain aggregation and attribution rules apply for determining whether one or more persons has acquired a 50% or greater interest in the distributing or controlled corporation. The aggregation rules of IRC section 355(d)(7)(A) apply. In addition, except as provided in regulations, IRC section 318(a)(2)(C) applies without regard to the amount of stock ownership of the corporation.

A public offering of sufficient size can result in an acquisition that causes gain recognition under the TRA of 1997 provision.

Acquisitions occurring within the four-year period beginning two years before the date of distribution and ending two years after the date of distribution are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The Treasury Department is authorized to prescribe regulations necessary to carry out the purposes of the provision, including regulations to provide for the application of the changes made by the TRA of 1997 in the case of multiple transactions.

Certain Transactions Not Considered Acquisitions - Under the TRA of 1997, certain specific types of transactions do not cause gain recognition or are not treated as acquisitions for purposes of determining whether there has been an acquisition of a 50% or greater interest in the distributing or the controlled corporation.

Single Affiliated Group - Under the TRA of 1997, a plan (or series of related transactions) is not one that will cause gain recognition if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group of corporations (as defined in IRC section 1504 without regard to subsection (b) thereof).

Continuing Direct or Indirect Ownership - Under the TRA of 1997, except as provided in Treasury regulations, certain acquisitions are not taken into account in determining whether a 50% or greater interest in the distributing or controlled corporation has been acquired. Generally, in any transaction, stock received directly or indirectly by former shareholders of the distributing or controlled corporation, in a successor or new controlling corporation of either, is not treated as acquired stock if it is attributable to such shareholders' stock in the distributing or controlled corporation that was not acquired as part of a plan or arrangement to acquire 50% or more of such successor or other corporation.

IRC section 355(e)(3)(A)(iv), as originally enacted, provided that an acquisition does not require gain recognition if the same persons own 50% or more of both

corporations, directly or indirectly before and after the acquisition and distribution, provided the stock owned before the acquisition was not acquired as part of a plan (or series of related transactions) to acquire a 50% or greater interest in either the distributing or controlled corporation.

Except as provided in Treasury regulations, certain other acquisitions also are not taken into account. For example, the following other types of acquisitions of stock are not subject to the provision, provided that the stock owned before the acquisition was not acquired pursuant to a plan or series of related transactions to acquire a 50% or greater ownership interest in either distributing or controlled corporation:

First, the acquisition of stock in the controlled corporation by the distributing corporation (as one example, in the case of a contribution of property by the distributing corporation to the controlled corporation in exchange for the stock of the controlled corporation);

Second, the acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (as one example, the receipt by a distributing corporation shareholder of controlled corporation stock in a distribution--including a split-off distribution in which a shareholder that did not own 50% of the stock of distributing owns 50% or more of the stock of the controlled corporation); and

Third, the acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation (for example, the receipt by former shareholders of the distributing corporation of 50% or more of the stock of a successor corporation in a merger involving the distributing).

The TRA of 1997 does not apply to distributions that would otherwise be subject to IRC section 355(d), which imposes corporate level tax on certain disqualified distributions.

The TRA of 1997 does not apply to a distribution pursuant to a title 11 or similar case.

IRC section 355(f) - The TRA of 1997 provides that, except as provided in Treasury regulations, IRC section 355 (or so much of IRC section 356 as relates to IRC section 355) shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in IRC section 1504(a)) to another member of such group (an "intragroup spin-off") if such distribution is part of a plan (or series of related transactions) described in IRC section 355(e)(2)(A)(ii), pursuant to which one or more persons acquire directly or indirectly stock representing a 50% or greater interest in the distributing corporation or any controlled corporation.

In determining whether an acquisition described in subsection 355(e)(2)(A)(ii) occurs, all the new provisions of IRC section 355(e) are applied. For example, an intragroup spin-off in connection with an overall transaction that does not cause gain recognition under IRC section 355(e) because it is described in IRC section 355(e)(2)(C), or because of IRC section 355(e)(3), or because of the effective date of IRC section 355(e), is not subject to the rule of IRC section 355(f).

The Treasury Department has regulatory authority to vary the result that the intragroup distribution under IRC section 355(f) does not qualify for IRC section 355 treatment. In this connection, the Treasury Department could by regulation eliminate some or all of the gain recognition required under IRC section 355(f) in connection with the issuance of regulations that would cause appropriate basis results with respect to the stock of S and T in the above example so that concerns regarding present law IRC section 355 basis rules (described below in connection with IRC section 358(c)) would be eliminated.

Treasury Regulatory Authority - The TRA of 1997 provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under IRC section 355 ("intragroup spin-off"), the Secretary of the Treasury is authorized under IRC section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution. It is understood that the approach of any such regulations applied to intragroup spin-offs that do not involve an acquisition may also be applied under the Treasury regulatory authority to modify the rule of IRC section 355(f) as may be appropriate.

Control Requirement for Certain Transactions - The TRA of 1997 also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of IRC section 355. In such cases, under IRC section 351 and modified IRC section 368(a)(2)(H) with respect to certain reorganizations under IRC section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50% interest in the vote and value of stock of the distributed corporation.

The TRA of 1997 does not change the requirement under IRC section 355 that the distributing corporation must distribute 80% of the voting power and 80% of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the TRA of 1997 regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80% control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80% controlled subsidiary, but generally would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

This Act conforms California law to the TRA of 1997 federal changes as it relates to certain distributions of controlled corporation stock, except in the application of consolidated return rules.

t. Reform Tax Treatment of Certain Corporate Stock Transfers (IRC §§304 &1059(e)).

Under the TRA of 1997, to the extent that a IRC section 304 transaction is treated as a distribution under IRC section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the

acquiring corporation in a transaction to which IRC section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the TRA of 1997 amends IRC section 1059 so that, if the IRC section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under IRC section 1059.

A special rule applies to transactions involving acquisitions by foreign corporations. The TRA of 1997 limits the earnings and profits of the acquiring foreign corporation that are taken into account. The earnings and profits of the acquiring foreign corporation to be taken into account will not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of IRC section 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of IRC section 1248(d) (relating to certain exclusions from earnings and profits with respect to foreign corporations) would apply. The Secretary of the Treasury is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

This Act conforms California law to the TRA of 1997 federal change as it relates to certain corporate stock transfers.

u. Treat Certain Preferred Stock as "Boot" (IRC §§351, 354, 355, 356 & 1036)

The TRA of 1997 amended the relevant provisions relating to corporate reorganization transactions to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either IRC section 351, 355, 368, or 1036, gain (or in some instances loss) is recognized.

The TRA of 1997 applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

In addition, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetence of the holder. Also, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

The following exchanges are excluded from this gain recognition requirement: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation is defined as any corporation if at least 50% of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in IRC section 447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with limited attribution rules for directly and indirectly owned stock of the corporation. Shares held by a family member are treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the shares, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of IRC section 2701 for estate and gift tax purposes continue to apply. An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under IRC section 354, but not IRC section 351.

In cases in which both sections 354 and 351 may apply to a transaction, IRC section 354 generally will apply for purposes of this provision. Thus, in that situation, the exchange would be tax free.

The TRA of 1997 also clarifies the treatment of certain conversion or exchange rights, by deleting any statutory reference to the existence of a "conversion privilege." The conferees wish to clarify that in no event will a conversion privilege to convert stock into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent.

The Joint Committee on Taxation report also clarifies that stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent for purposes of the provision.

The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306, 318, and 368(c)).

Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

This Act conforms California law to the TRA of 1997 federal change as it relates to the treatment of certain preferred stock as "boot".

v. Extend UBIT Rules to Second-Tier Subsidiaries and Amend Control Test (IRC §512).

The TRA of 1997 modifies the test for determining control for purposes of IRC section 512(b)(13). Under the TRA of 1997, "control" means (in the case of a stock corporation) ownership by vote or value of more than 50% of the stock. In the case of a partnership or other entity, control means ownership of more than 50% of the profits, capital or beneficial interests. In addition, the TRA of 1997 applies the constructive ownership rules of IRC section 318 for purposes of IRC section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50% of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second or lower-tier subsidiary).

The TRA of 1997 also makes technical modifications to the method provided in IRC section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includible in the latter organization's UBI. Such payments are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

This Act conforms California law to the TRA of 1997 federal change as it relates to the extension of UBIT rules to second-tier subsidiaries and the control test.

w. Allocation of Basis Among Properties Distributed by Partnership (IRC §§732,751).

The TRA of 1997 modified the basis allocation rules for distributee partners of a partnership. It allocates a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under prior federal law). If the basis to be allocated is less than the sum of the adjusted bases of the properties to the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the total basis to be allocated, the decrease is allocated as described below for adjustments that are decreases.

Basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. For example, assume that a partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10. Under the provision, basis is

first allocated to asset A in the amount of 5 and to asset B in the amount of 10 (their adjusted bases to the partnership). The remaining basis adjustment is an increase totaling 40 (the partner's 55 basis minus the partnership's total basis in distributed assets of 15). Basis is then allocated to asset A in the amount of 35, its unrealized appreciation, with no allocation to asset B attributable to unrealized appreciation because its fair market value equals the partnership's adjusted basis. The remaining basis adjustment of 5 is allocated in the ratio of the assets' fair market values, i.e., 4 to asset A (for a total basis of 44) and 1 to asset B (for a total basis of 11).

If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made). A remaining basis adjustment that is a decrease arises under the provision when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties.

For example, assume that a partnership with two assets, C and D, distributes them both in liquidation to a partner whose basis in its partnership interest is 20. Neither asset consists of inventory or unrealized receivables. Asset C has a basis to the partnership of 15 and a fair market value of 15, and asset D has a basis to the partnership of 15 and a fair market value of 5. Under the TRA of 1997, basis is first allocated to the extent of the partnership's basis in each distributed property, or 15 to each distributed property, for a total of 30. Because the partner's basis in its interest is only 20, a downward adjustment of 10 (30 minus 20) is required. The entire amount of the 10 downward adjustment is allocated to property D, reducing its basis to 5. Thus, the basis of property C is 15 in the hands of the distributee partner, and the basis of property D is 5 in the hands of the distributee partner.

This Act conforms California law to the TRA of 1997 federal change as it relates to the allocation of basis among properties distributed by partnership.

x. Extension of Time for Taxing Pre-Contribution Gain (IRC §737(b)).

The TRA of 1997 extends from five to seven years the period during which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the provision, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, if the distribution occurs within seven years after the contribution to the partnership.

This Act conforms California law to the TRA of 1997 federal change as it relates to the time for taxing pre-contribution gain from the contribution of appreciated property to a partnership.

y. Cashout of Certain Accrued Benefits (IRC §§411(a), 417(e) & 457(e)).

Under federal and state law, in the case of an employee whose retirement plan participation terminates, a qualified plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent and, if applicable, the consent of the participant's spouse).

The TRA of 1997 increased the limit on involuntary cash outs from \$3,500 to \$5,000. The \$5,000 amount is adjusted for inflation beginning after 1998 in \$50 increments.

This Act conforms California law to the TRA of 1997 federal change as it relates to the cash out of certain accrued benefits.

z. Taxable Cash Compensation in lieu of Nontaxable Parking Benefits (IRC §132(f)).

Under federal and state law, up to \$170 per month of employer-provided parking is excludable from gross income.

Under the TRA of 1997 no amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

This Act conforms California law to the TRA of 1997 federal change as it relates to the taxability of parking benefits. This Act does not affect a state exclusion that is available for compensation or benefits received for participation in a ridesharing arrangement.

aa. Basis Recovery Rules for Annuities Over More Than One Life (IRC §72(d)).

The portion of each annuity payment that represents a return of basis generally is determined by a simplified method. Under this method, the portion of each annuity payment that is a return of basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a "specified table." The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

Under prior and present federal law the specified table applies to benefits based on the life of one annuitant. Under the TRA of 1997, a separate table applies to benefits based on the life of more than one annuitant.

Combined age of annuitants	Number of payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

The TRA of 1997 clarifies that the new table applies to benefits based on the life of more than one annuitant, even if the amount of the annuity varies by annuitant. Thus, for example, the new table applies to a 50% joint and survivor annuity. The new table does not apply to an annuity paid on a single life merely because it has

additional features, e.g., a term certain.

This Act conforms California law to the TRA of 1997 federal change as it relates to the basis recovery of annuities. The past differences in amounts may still cause the amounts to be different.

bb. Involuntarily Converted Property Acquired from an Unrelated Person (IRC §1033).

The TRA of 1997 expands the denial of the application of involuntary conversion tax treatment to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by sections 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of \$100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual \$100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

This Act conforms California law to the TRA of 1997 federal change as it relates to replacement property in involuntary conversions.

cc. Exception from Installment Sales Rules for Sales by a Manufacturer (IRC §811).

The TRA of 1997 repealed the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers. The repeal is effective for tax beginning after August 6, 1998.

This Act conforms California law to the TRA of 1997 federal change as it relates to the installment sales rules for certain sales by manufacturers to dealers with the same effective date.

dd. Limitations on Charitable Remainder Trust Eligibility (IRC §§664 & 2055(e)).

Under the TRA of 1997, a trust cannot be a charitable remainder annuity trust if the annuity for any year is greater than 50% of the initial fair market value of the trust's assets or be a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50%. Any trust that fails this 50% rule will not be a charitable remainder trust whose taxation is governed under IRC section 664, but will be treated as a complex trust and, accordingly, all its income will be taxed to its beneficiaries or to the trust.

In addition, the value of the charitable remainder with respect to any transfer to a qualified charitable remainder annuity trust or charitable remainder unitrust is required to be at least 10% of the net fair market value of such property transferred in trust on the date of the contribution to the trust. The 10% test is measured on each transfer to the charitable remainder trust and, consequently, a charitable remainder trust which meets the 10% test on the date of transfer will not subsequently fail to meet that test if interest rates have declined between the trust's creation and the death of a measuring life. Similarly, where a charitable remainder trust is created for the joint lives of two individuals with a remainder to charity, the trust will not cease to qualify as a charitable remainder trust because the value of the charitable remainder was less than 10% of the trust's

assets at the first death of those two individuals.

The TRA of 1997 provides several additional rules in order to provide relief for trusts that do not meet the 10% rule. First, where a transfer is made after July 28, 1997, to a charitable remainder trust that fails the 10% test, the trust is treated as meeting the 10% requirement if the governing instrument of the trust is changed by reformation, amendment, construction, or otherwise to meet such requirement by reducing the payout rate or duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement so long as the reformation is commenced within the period permitted for reformations of charitable remainder trusts under IRC section 2055(e)(3). The statute of limitations applicable to a deficiency of any tax resulting from reformation of the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been reformed. In substance, this rule relaxes the requirements of IRC section 2055(e)(3)(B) to the extent necessary for the reformation for the trust to meet the 10% requirement.

Second, a transfer to a trust will be treated as if the transfer never had been made where a court having jurisdiction over the trust subsequently declares the trust void (because, e.g., the application of the 10% rule frustrates the purposes for which the trust was created) and judicial proceedings to revoke the trust are commenced within the period permitted for reformations of charitable remainder trusts under IRC section 2055(e)(3). Under this provision, the effect of "unwinding" the trust is that any transactions made by the trust with respect to the property transferred (e.g., income earned on the assets transferred to the trust and capital gains generated by the sales of the property transferred) would be income and capital gain of the donor (or the donor's estate if the trust was testamentary), and the donor (or the donor's estate if the trust was testamentary) would not be permitted a charitable deduction with respect to the transfer. The statute of limitations applicable to a deficiency of any tax resulting from "unwinding" the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been revoked.

Third, where an additional contribution is made after July 28, 1997, to a charitable remainder unitrust created before July 29, 1997, and that unitrust would not meet the 10% requirement with respect to the additional contribution, the conference agreement provides that such additional contribution will be treated, under regulations to be issued by the Secretary of the Treasury, as if it had been made to a new trust that does not meet the 10% requirement, but which does not affect the status of the original unitrust as a charitable remainder trust.

The committee reports indicated that Congress intends that this provision not limit or alter the validity of regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

This Act conforms California law to the TRA of 1997 federal change as it relates to limitations on charitable remainder trust eligibility.

ee. Estimated Tax Requirements of Individuals (IRC §6654(d)).

For individual taxpayers with AGI greater than \$150,000 (\$75,000 if married filing

a separate return), the TRA of 1997 changed the 110% of prior year's liability safe harbor to be a 100% of last year's liability safe harbor for taxable years beginning in 1998, a 105% of last year's liability safe harbor for taxable years beginning in 1999, 2000, and 2001, and a 112% of last year's liability safe harbor for taxable years beginning in 2002.

In addition, no estimated tax penalties will be imposed under sections 6654 or 6655 for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to any underpayment to the extent such underpayment is created or increased by a provision of the TRA of 1997.

This Act conforms California law to the TRA of 1997 federal change as it relates to the prior year exception from the estimated tax penalty. This Act also provides that no estimate tax penalty would apply to any tax payment made before April 16, 1999, to the extent the underpayment was created or increased by a provision in this bill.

ff. Simplify Treatment of Personal Transactions in Foreign Currency (IRC §988(e)).

Under the TRA of 1997, if an individual acquires foreign currency and disposes of it in a personal transaction, and the exchange rate changes between the acquisition and disposition of such currency, nonrecognition treatment applies to any resulting exchange gain, provided that such gain does not exceed \$200. The provision does not change the treatment of resulting exchange losses.

Transactions entered into in connection with a business trip constitute personal transactions for purposes of this provision. Exchange gain resulting from such transactions is eligible for nonrecognition treatment under this provision.

This Act conforms California law to the TRA of 1997 federal change as it relates to personal transactions in foreign currency.

gg. Treatment of Certain Reimbursed Expenses of Rural Mail Carriers(IRC §162)).

The TRA of 1997 provides that for employees using their automobile in performing services involving the collection and delivery of mail on a rural route and reimbursed by the U.S. Postal Service at a rate contained in their 1991 collective bargaining agreement, their business expense deduction is equal to the reimbursement, which may be increased by no more than the rate of inflation. Under this treatment, income and expenses would be equal, so that neither will have to be reported on the taxpayer's tax return.

This Act conforms California law to the TRA of 1997 federal change as it relates to rural mail carriers' reimbursement allowance for mileage.

hh. Travel Expenses for Certain Federal Employees (IRC §162(a)).

The TRA of 1997 provides that the one-year limitation with respect to deductibility of an employee's expenses while temporarily away from home does not include any period during which a federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the federal government in a

temporary duty status to investigate or provide support services to the investigation of a federal crime. Therefore, expenses for these individuals during these periods are deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

This Act conforms California law to the TRA of 1997 federal change as it relates to travel expenses for certain federal employees.

ii. Closing of Partnership Year with Respect to Deceased Partner (IRC §706(c)).

The TRA of 1997 provided that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change the law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

This Act conforms California law to the TRA of 1997 federal change as it relates to the closing of the partnership year with respect to a deceased partner.

jj. Items Relating to Income Taxation of Estates (IRC §§267(b) & 1239(b)).

Certain Revocable Trusts as Part of Estate - The TRA of 1997 provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes. This elective treatment is effective from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or, if later, six months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor of the decedent's estate (if any) and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. A conforming change is made to IRC section 2652(b) for generation-skipping transfer tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated under IRC section 676 as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). The separate share rule (described above) generally will apply when a qualified revocable trust is treated as part of the decedent's estate.

Executor of Estate and Beneficiaries Treated as Related Persons for Disallowance of Losses - Under the TRA of 1997, an estate and a beneficiary of that estate are treated as related persons for purposes of IRC sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

This Act conforms California law to the TRA of 1997 federal change as it relates to the income taxation of the income of estates and trusts.

kk. Pension Simplification Provisions (IRC §§401(a), 402, 403(b), 409 & 410(c)).

Matching Contributions of Self-Employed Individuals Not Treated as Elective Deferrals - The TRA of 1997 provides that matching contributions for self-employed individuals are treated the same as matching contributions for employees, i.e., they are not subject to the elective deferral limits and are not treated as elective deferrals for purposes of the "average deferral percentage" (ADP) test (unless the employer elects to treat qualified matching contributions as elective deferrals under the ADP test). The provision does not apply to qualified matching contributions that are treated as elective deferrals for purposes of satisfying the ADP test.

Modification of Prohibition on Assignment or Alienation - The TRA of 1997 permits a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of ERISA, or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset is required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50% survivor annuity for the spouse. An offset is includible in income on the date of the offset (except to the extent attributable to the employee's basis).

Permanent Moratorium on Application of Nondiscrimination Rules to State and Local Governmental Plans - The TRA of 1997 provides that state and local governmental plans are permanently exempt from the nondiscrimination and minimum participation rules. The exemption from the nondiscrimination and participation rules includes exemption from the ADP and "average contribution percentage" (ACP) tests. A cash or deferred arrangement under a governmental plan is treated as a qualified cash or deferred arrangement even though the ADP test is not in fact satisfied. Thus, for example, elective contributions made by a governmental employer on behalf of an employee are not treated as distributed or made available to the employee (in accordance with IRC section 402(e)(3)).

Clarification of Certain Rules Relating to ESOPs of S Corporations - The TRA of 1997 provides that ESOPs of S corporations may distribute cash to plan participants. Such a plan may distribute employer securities as long as the employee has a right to require the employer to purchase the securities (as under the rules applicable to ESOPs generally). In addition, the TRA of 1997 provides that the statutory exceptions to the prohibited transaction rules do not fail to apply merely because a transaction involves the sale of employer securities to an ESOP maintained by an S corporation by a shareholder employee, a family member of the shareholder employee, or a corporation controlled by the shareholder employee. Thus, the statutory exemptions for such a transaction (including the exemption for a loan to the ESOP to acquire employer securities in connection with such a sale or a guarantee of such a loan) apply. The provision is effective for taxable years beginning after December 31, 1997.

Modify Funding Requirements for Certain Plans - The TRA of 1997 modifies the minimum funding requirements in the case of certain plans. The TRA of 1997 applies

in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The TRA of 1997 treats a plan to which it applies as having a funded current liability percentage of at least 90% for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90% if the actual funded current liability percentage is at least at certain specified levels.

The relief from the minimum funding requirements applies for plan years beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

Plans Not Disqualified Merely by Accepting Rollover Contributions - The TRA of 1997 directs the Secretary of the Treasury to clarify that, under its regulations protecting plans from disqualification because they receive invalid rollover contributions, it is not necessary for a distributing plan to have a determination letter in order for the administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover.

This Act conforms California law to the TRA of 1997 federal change as it relates to various pension provisions described above.

11. Miscellaneous Provisions Relating to Pensions and Other Benefits (IRC §§401(a)&(k), 404(a), 412(c), 414(e), 415, 512(e), 664, & 674(b)).

Increase in Full Funding Limit - The TRA of 1997 increases the 150% of current liability full funding limit as follows: 155% for plan years beginning in 1999 or 2000, 160% for plan years beginning in 2001 or 2002, 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In addition, amounts that cannot be contributed due to the current liability full funding limit are amortized over 20 years. Amounts that could not be contributed because of the prior-law current liability full funding limit and that have not been amortized as of the last day of the last plan year beginning in 1998 are amortized over this 20-year period. With respect to amortization bases remaining at the end of the 1998 plan year, the 20-year amortization period is reduced by the number of years since the amortization base had been established. No amortization is required with respect to funding methods that do not provide for amortization bases.

Contributions on Behalf of a Minister to a Church Plan - The TRA of 1997 provides that in the case of a contribution made to a church plan on behalf of a minister who is self-employed, the contribution is excludable from the income of the minister to the extent that the contribution would be excludable if the minister were an employee of a church. The provision does not alter present law under which amounts contributed for a minister in connection with IRC section 403(b), either by the minister's actual employer or by any church or convention or association of

churches that is treated as the minister's employer under IRC section 414(e), are excluded from the minister's income, and amounts contributed in accordance with IRC section 403(b) by the minister (whether the minister is an employee or is self-employed) are deductible by the minister as provided in IRC section 404 taking into account the other special rules of IRC section 414(e). A minister will not be entitled to both an exclusion and deduction for the same contribution.

Exclusion of Ministers from Discrimination Testing of Certain Non-Church Retirement Plans - The TRA of 1997 provides that if a minister is employed by an organization other than a church and the organization is not otherwise participating in the church plan, then the minister does not have to be included as an employee under the retirement plan of the organization for purposes of the nondiscrimination rules. The provision is effective for years beginning after December 31, 1997.

Repeal Application of UBIT to ESOPs of S Corporations - The TRA of 1997 repeals the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder. The repeal of such provision applies only with respect to employer securities held by an employee stock ownership plan (as defined in IRC section 4975(e)(7)) maintained by an S corporation.

Cash or Deferred Arrangements for Irrigation and Drainage Entities - Under the TRA of 1997, mutual irrigation or ditch companies and districts organized under the laws of a state as a municipal corporation for the purpose of irrigation, water conservation or drainage (or a national association of such organizations) are permitted to maintain qualified cash or deferred arrangements, even if the company or district is a state or local governmental organization.

Portability of Permissive Service Credit under Governmental Pension Plans - Under the TRA of 1997, contributions by a participant in a state or local governmental plan to purchase permissive service credits are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the \$30,000 limit on annual additions is met for the year (taking into account any other annual additions of the participant). Under the first alternative, a plan will not fail to satisfy the reduced defined benefit pension plan limit that applies in the case of early retirement due to the accrued benefit derived from the purchase of permissive service credits. These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Under the TRA of 1997, permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the plan. IRC section 415 is violated if more than 5 years of permissive service credit is purchased for "nonqualified service." In addition, IRC section 415 is violated if nonqualified service is taken into account for an employee who has less than five years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, state, or local government employee, (2) as an employee of an association representing federal, state or local government employees, (3) as

an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

The TRA of 1997 provides that in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment shall not be taken into account for purposes of IRC section 415 and service credit obtained as a result of the repayment shall not be considered permissive service credit.

The provision is not intended to affect the application of "pick up" contributions to purchase permissive service credit or the treatment of pick up contributions under IRC section 415. The provision does not apply to purchases of service credit for qualified military service under the rules relating to veterans' reemployment rights.

The TRA of 1997 provides a transition rule for plans that provided for the purchase of permissive service credit prior to enactment of the TRA of 1997. Under this rule, the defined contribution limits will not reduce the amount of permissive service credit of an eligible participant allowed under the terms of the plan as in effect on the date of enactment. For this purpose an eligible participant is an individual who first became a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of the enactment of TRA of 1997) of the governing body with authority to amend the plan ends.

Removal of Dollar Limitation on Benefit Payments from a Defined Benefit Plan for Police and Fire Employees - Under the TRA of 1997, the dollar limit on defined benefit plans does not apply to the reduction for early retirement benefits for individuals who received the special rule for certain police and fire department employees under prior law. Thus, the defined benefit plan dollar limit continues to apply, but is not reduced in the case of early retirement. As under present law, the dollar limit is increased for such employees if benefits begin after age 65.

Gratuitous Transfers for the Benefit of Employees - The TRA of 1997 permits certain limited transfers of qualified employer securities by charitable remainder trusts to ESOPs without adversely affecting the status of the charitable remainder trusts under IRC section 664. As a result, the TRA of 1997 provides that a qualified gratuitous transfer of employer securities to an ESOP is deductible from the gross estate of a decedent under IRC section 2055 to the extent of the present value of the remainder interest. In addition, an ESOP will not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

In order for a transfer of securities to be a "qualified gratuitous transfer," the following requirements must be satisfied: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members of the decedent own (directly or indirectly) no more than 10% of the value of the outstanding stock of the company; (3) immediately after the transfer to the ESOP, the ESOP owns at least

60% of the value of outstanding stock of the company (the 60% requirement is determined assuming that outstanding options have been exercised); and (4) the plan meets certain requirements. In order to prevent erosion of the 60% ownership requirements, an excise tax is imposed on the employer maintaining the ESOP with respect to certain dispositions of the transferred stock within three years of the transfer.

In order for a transfer to qualify as a gratuitous transfer, the ESOP must contain certain provisions. First, the plan must provide that plan participants are entitled to direct the manner in which stock transferred are to be voted (with respect to all matters). Transferred securities that have not yet been allocated to participants must be voted by a trustee that is not a 5% owner of the company or a family member of the decedent.

Second, the plan must provide that participants have the right to receive distributions in the form of stock and that the participant can require the employer to repurchase any shares distributed under a fair valuation formula. For this purpose, a valuation formula is not considered fair if it takes into account a discount for minority interests.

Finally, the plan must provide that, if the plan is terminated before all the transferred stock has been allocated, the remaining stock is to be transferred to one or more charitable organizations. The employer is subject to an excise tax designed to recapture the estate taxes that would have been due had the transfer to the ESOP not occurred if the plan is terminated and any unallocated shares are not transferred to charitable organizations.

No deduction is permitted under IRC section 404 with respect to securities transferred from the charitable remainder trust. The nondiscrimination requirements normally applicable to qualified plans must be satisfied with respect to the securities transferred. The ESOP is required to treat the securities transferred as employer securities, except for purposes of determining the amount of deductible contributions to the plan otherwise permitted by the employer. The ESOP is required to allocate the transferred securities up to the limit on contributions and benefits after allocating any other employer contributions for the year; any transferred securities that cannot be allocated because of the IRC section 415 limits would be held in a suspense account and allocated in the same manner in subsequent years. Transferred securities are not taken into account in determining whether any other contributions satisfy the IRC section 415 limit. Further, securities transferred to an ESOP by a charitable remainder trust cannot be allocated to the account of (1) any family member of the decedent, or (2) any employee owning more than 5% of any class of outstanding stock of the corporation issuing the securities (or a member of a controlled group of corporations) or the total value of any class of outstanding stock of any such corporation. The employer is subject to an excise tax if impermissible allocations are made.

Qualified employer securities include only employer securities (within the meaning of IRC section 409(1) which are issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market and that has only one class of stock.

This Act conforms California law to the TRA of 1997 federal changes as relating to pensions and other benefits described above.

mm. Creation of Medicare+Choice Medical Savings Accounts (IRC §§138 & 220(b)(7)).

Under the Balanced Budget Act of 1997 (BBA of 1997), individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a Medicare+Choice Medical Savings Accounts (MSA) plan. Individuals who are eligible for Medicare are not eligible for an MSA that is not a Medicare+Choice MSA. To the extent an individual chooses such a plan, the Secretary of Health and Human Services makes a specified contribution directly into a Medicare+Choice MSA designated by such individual. Only contributions by the Secretary of Health and Human Services can be made to a Medicare+Choice MSA and such contributions are not included in the taxable income of the Medicare+Choice MSA holder. Income earned on amounts held in a Medicare+Choice MSA are not currently includible in taxable income. Withdrawals from a Medicare+Choice MSA are excludable from taxable income if used for the qualified medical expenses of the Medicare+Choice MSA holder. Medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Withdrawals from a Medicare+Choice MSA that are not used for the qualified medical expenses of the account holder are includible in income and may be subject to an additional tax (described below).

Definition of Medicare+Choice MSAs - A Medicare+Choice MSA is an MSA that is designated as Medicare+Choice MSA and to which contributions can be made only by the Secretary of Health and Human Services. Medicare+Choice MSAs are not taken into account for purposes of the cap on non-Medicare+Choice MSAs, nor are they subject to that cap. Thus, a Medicare+Choice MSA is a tax-exempt trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account holder that meets requirements similar to those applicable to IRAs. The trustee of a Medicare+Choice MSA can be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person will administer the trust will be consistent with applicable requirements.

A Medicare+Choice MSA trustee is required to make such reports as may be required by the Secretary of the Treasury. A \$50 penalty is imposed for each failure to file without reasonable cause.

Taxation of Distributions from a Medicare+Choice MSA - Distributions from a Medicare+Choice MSA that are used to pay the qualified medical expenses of the account holder are excludable from taxable income regardless of whether the account holder is enrolled in the Medicare+Choice MSA plan at the time of the distribution. Under the provision, medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Qualified medical expenses are defined as under the rules relating to the itemized deduction for medical expenses. However, for this purpose, qualified medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation insurance (so-called "COBRA coverage"), or premiums for coverage while an individual is receiving unemployment compensation. Distributions from a Medicare+Choice MSA that are excludable from gross income under the provision cannot be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses are includible in taxable income. An additional tax of 50% applies to the extent the total distributions for purposes other than qualified medical expenses in a taxable year exceed the amount by which the value of the Medicare+Choice MSA as of December 31

of the preceding year exceeds 60% of the deductible of the plan under which the individual is covered on January 1 of the current year. The additional tax does not apply to distributions on account of the disability or death of the account holder.

Following is an example of how the amount available to be withdrawn from a Medicare+Choice MSA without penalty is calculated. The numbers are provided for illustrative purposes only.

	Year 1	Year 2	Year 3	Year 4

1. Deductible.....	\$3,000	\$3,000	\$3,000	\$3,000
2. 60% of deductible.....	1,800	1,800	1,800	1,800
3. Contributions.....	1,300	1,300	1,300	1,300
4. Earnings.....	130	200	300	400
5. Total withdrawals.....	600	500	600	600
6. Closing balance (Dec. 31 of current year).....	830	1,830	2,830	3,930
7. Amount available for nonmedical withdrawal without penalty	0	0	30	1,030

Direct trustee-to-trustee transfers can be made from one Medicare+Choice MSA to another Medicare+Choice MSA without income inclusion.

The provision includes a correction mechanism so that if contributions for a year are erroneously made by the Secretary of Health and Human Services, such erroneous contributions can be returned to the Secretary of Health and Human Services (along with any attributable earnings) from the Medicare+Choice MSA without tax consequences to the account holder.

Treatment of Medicare+Choice MSA at Death - Upon the death of the account holder, if the beneficiary of the Medicare+Choice MSA is the account holder's surviving spouse, the surviving spouse may continue the Medicare+Choice MSA, but no new contributions can be made. Distributions from the Medicare+Choice MSA are subject to the rules applicable to MSAs that are not Medicare+Choice MSAs. Thus, earnings on the account balance are not currently includible in income. Distributions from the account for the qualified medical expenses of the spouse or the spouse's dependents (or subsequent spouse) are not includible in income. Distributions used for other than medical expenses are includible in income, and subject to a 15% excise tax unless the distribution is made after the surviving spouse attains age 65, dies, or becomes disabled.

If the beneficiary of a Medicare+Choice MSA is not the account holder's spouse, the Medicare+Choice MSA is no longer treated as a Medicare+Choice MSA and the value of the Medicare+Choice MSA on the account holder's date of death is included in the taxable income of the beneficiary for the taxable year in which the death occurred (under the rules applicable to MSAs generally). If the account holder fails to name a beneficiary, the value of the Medicare+Choice MSA on the account holder's date of death is to be included in the taxable income of the account holder's final income tax return (under the rules applicable to MSAs generally).

In all cases, the value of the Medicare+Choice MSA is included in the account holder's gross estate for estate tax purposes.

This Act conforms California law to federal law as it relates to Medicare+Choice MSA.

2.
Section **17052.12** of the Revenue and Taxation Code is amended.

This Act makes a technical correction to the adoption credit provision by removing the word "only" from the carryover language contained in the section. The use of "only" implies the credit may only be claimed in the year the adoption is completed, when any unused credit may be carried over to succeeding years.

3.
Sections **17053.36, 17053.37, 23636 and 23637**, of the Revenue and Taxation Code are added.

Joint Strike Fighter Program Credits.

The Joint Strike Fighter (JSF) Program Credits provisions of **this Act** create a wage credit and a property credit for the JSF program under both the PITL and B&CTL. These credits apply to taxpayers under initial contract or subcontract to manufacture property for ultimate use in a JSF. The credits are available for taxable years beginning on or after January 1, 2001, and before January 1, 2006. Any excess credit can be carried forward for up to eight years. No credit is allowed unless the bid upon which the JSF contract or subcontract is based is reduced by the credit amount. The taxpayer is required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

The wage credit is equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004 and 10% for 2005) of employee wages that are treated as direct costs under Section 263A of the IRC allocable to property manufactured in this state for ultimate use in a JSF. The wages can be paid to new or existing employees whose services for the taxpayer are at least 90% directly related to the contract or subcontract to manufacture property for ultimate use in a JSF. The credit is limited to \$10,000 per year, per employee, and be prorated for partial years.

The property credit is generally patterned after the MIC and it is equal to 10% of the cost of qualified property. Qualified property means tangible personal property (IRC Section 1245(a)(3)(A)), and capitalized labor costs that are treated as direct costs under Section 263A of the IRC allocable to that property, used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

Certain types of property are excluded from the definition of qualified property, including furniture, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing. The Act provides special rules for costs paid pursuant to a binding contract and leased property.

The credit is recaptured if, within one year of being placed in service, the property is sold, moved out of state or used for purposes other than manufacturing a product for ultimate use in a JSF.

The taxpayer is not allowed this credit and the MIC for the same property.

This Act specifies that the credits are operable for taxable or income years beginning on or after January 1, 2001, and before January 1, 2006.

4.
Section **17053.5** of the Revenue and Taxation Code is amended

Renter's Credit Modification.

Current state law allows qualifying renters a refundable credit of \$60 or \$120, based on filing status. The credit is not related to the amount of rent paid. The renters' credit has been suspended for the 1993 through 1997 tax years, but by statute is reinstated effective January 1, 1998, for the 1998 taxable year.

This Act amends the existing renter's credit to allow a nonrefundable credit amount of \$120 for married filing joint returns, heads of household and surviving spouses if adjusted gross income is \$50,000 or less, and \$60 for other individuals (single or married for separate) if adjusted gross income is \$25,000 or less.

This Act also requires the FTB to recompute the adjusted gross income amounts annually for inflation.

5.
Section **17054** of the Revenue and Taxation Code is amended

Dependent Exemption Changes

This Act increases the dependent exemption credit amount from \$120 to \$253 for the 1998 taxable year and from \$222 to \$227 for the 1999 taxable year and thereafter. The increased credit will be adjusted for inflation after the 1999 taxable year. These increased credit amounts continue to be subject to the tentative minimum tax limitations.

6.
Section **17062** of the Revenue and Taxation Code is amended

This Act clarifies the operative date regarding the allowance of the installment method used by farmers in computing alternative minimum taxable income.

7.
Section **17062.5** of the Revenue and Taxation Code is added.

This Act prevents California law from conforming to the federal reduced rate of tax on capital gains. This provision is necessary due to the "date change" provision contained in this Act.

8.
Section **17073.5** of the Revenue and Taxation Code is amended.

Increase Standard Deduction & AMT Exemption Amount for Kiddie Tax (IRC §§59 & 63).

The TRA of 1997 changed the standard deduction for dependents. The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) \$500 (indexed for inflation from calendar year 1987, which is the same as prior law), or (b) the individual's earned income plus \$250 (indexed for inflation after calendar year 1998).

The TRA of 1997 also changed the AMT exemption for children under age 14. The AMT exemption for a child under age 14 is the lesser of (1) \$33,750 or (2) the sum of the child's earned income plus \$5,000 (indexed for inflation after calendar year 1998).

This Act conforms California law to the TRA of 1997 federal change as it relates to the AMT exemption and standard deduction amounts for kiddie tax.

9.

Sections **17140.3** and **23711** of the Revenue and Taxation Code are added.

This Act conforms California law by reference to IRC section 529 qualified state tuition program rules. The Golden State Scholarshare Trust Act was created in AB 530 (Ch. 851, Stat. 1997). AB 530 specifically exempted the earnings from the Golden State Scholarshare Trust from tax using stand alone language and is not superseded by this Act.

By conforming to IRC section 529, **this Act** provides tax-exempt status to "qualified State tuition programs," meaning programs established and maintained by any state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, room and board expenses, and equipment required for enrollment or attendance at a college or university (or certain vocational schools).

In addition, the law provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent or other relative receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.

10.

Section **17273.1** of the Revenue and Taxation Code is added.

Increase in Self-Employed Health Insurance Deduction (IRC §162(l)).

Under the PITL, **this Act** allows a 40% deduction of the cost of health insurance incurred by a self-employed individual in the computation of AGI only for taxable years beginning in 1998.

11.

Section **17276** of the Revenue and Taxation Code is amended.

This Act makes technical changes to the "net operating loss" provision by deleting from the phrase "taxpayer or partnership" the words "or partnership" (partnerships are defined as taxpayers). The Act also replaced a reference to the prior federal carry forward period of 15 years with the present federal carry forward period of 20 years.

12.

Sections **17279.4** and **24369.4** of the Revenue and Taxation Code is added.

Expensing of Environmental Remediation Costs ("Brownfields") (IRC §198).

The TRA of 1997 provided that taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in Comm'r v. Idaho Power Co., 418 U.S. 1 (1974), and the IRC are treated as qualified environmental remediation expenditures. (Comm'r v. Idaho Power Co. held that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under IRC section 263(a)(1)).

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas would mean (1) empowerment zones and enterprise communities as designated under present law and under the TRA of 1997 (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) cannot be targeted areas.

With respect to certification of targeted areas, the TRA of 1997 provides that the chief executive officer of a state may, in consultation with the Administrator of the EPA, designate an appropriate state environmental agency. If no state environmental agency is so designated within 60 days of the date of enactment, the

appropriate environmental agency for such state shall be designated by the Administrator of the EPA.

Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The TRA of 1997 further provides that, in the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the TRA of 1997 is treated as a depreciation deduction and the property is treated as subject to IRC section 1245 property. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

This Act conforms California law to the TRA of 1997 federal change as it relates to the election to expense environmental remediation costs. This Act does not permit a separate election for state purposes.

13.

Section **17279.5** of the Revenue and Taxation Code is added and section **24424** of the Revenue and Taxation Code is amended.

Denial of Deduction for Certain Amounts Paid in Connection with Insurance. (IRC §§101(a), 264, 265, 805, 807, 812, 832)

Under the TRA of 1997, the prior federal law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

The premium deduction limitation does not apply to premiums with respect to any annuity contract described in IRC section 72(s)(5) (relating to certain qualified pension plans, certain retirement annuities, individual retirement annuities, and qualified funding assets), or to premiums with respect to any annuity to which IRC section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person).

Under TRA of 1997, no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest when the contract is first issued under applicable state law when the contract is first issued, except as otherwise provided under existing federal law with respect to key persons and pre-1986 contracts.

The TRA of 1997 specifies the treatment of certain interest to which the provision providing for expansion of interest disallowance to individuals in whom a taxpayer has an insurable interest otherwise would apply. The conference agreement provides that in the case of a transfer for valuable consideration of a life insurance contract or any interest therein described in IRC section 101(a)(2), the amount of the death benefit excluded from gross income under IRC section 101(a) may not

exceed an amount equal to the sum of the actual value of the consideration, premiums, interest disallowed as a deduction under new IRC section 264(a)(4), and other amounts subsequently paid by the transferee. Thus, under the provision, in the case of the transfer for value of a life insurance contract, the interest with respect to the contract that otherwise would be disallowed under new IRC section 264(a)(4) is capitalized, reducing the amount included in income by the transferee upon receipt by the transferee of the amounts paid by reason of the death of the insured.

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer.

This rule does not apply to any policy or contract owned by an entity engaged in a trade or business covering an individual who is an employee, officer or director of the trade or business at the time first covered. Under the conference agreement, the exception applies to any policy or contract owned by an entity engaged in a trade or business which covers one individual who (at the time first insured under the policy or contract) is (1) a 20% owner of the entity, or (2) an individual (who is not a 20% owner) who is an officer, director or employee of the trade or business. The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20% owner and the spouse of the 20% owner.

A joint-life contract under which the sole insureds are a 20% owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception. Thus, for example, if the insureds under a contract include an individual described in the exception (e.g., an employee, officer, director, or 20% owner) and any individual who is not described in the exception (e.g., a debtor of the entity), then the exception does not apply to the policy or contract. For purposes of this exception, a 20% owner has the same meaning as under present-law IRC section 264(d)(4). In addition, the TRA of 1997 provides that the pro rata interest disallowance rule does not apply to any annuity contract to which IRC section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person). The TRA of 1997 provides that any policy or contract that is not subject to the pro rata interest disallowance rule by reason of this exception (for 20% owners, their spouses, employees, officers and directors, and in the case of an annuity contract to which IRC section 72(u) applies) is not taken into account in applying the ratio to determine the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the cash value of a contract.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract is treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value is treated as not exceeding the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the provision applies at the partnership or corporate level. The amount of the benefit is intended to take into account the amount payable to the business under the contract (e.g., as a death benefit) or pursuant to another agreement (e.g., under a split dollar agreement). The amount of the benefit is intended also to include any amount by which liabilities of the business would be reduced by payments under the policy or contract (e.g., when payments under the policy reduce the principal or interest on a liability owed to or by the business).

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report the amount of the unborrowed cash value in order to carry out this rule.

If interest expense is disallowed under other provisions of IRC section 264 (limiting interest deductions with respect to life insurance policies or endowment or annuity contracts) or under IRC section 265 (relating to tax-exempt interest), then the disallowed interest expense is not taken into account under this provision, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The provision is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property.

An aggregation rule is provided treating related persons as one for purposes of the provision. The aggregation rule is intended to prevent taxpayers from avoiding the pro rata interest limitation by owning life insurance, endowment or annuity contracts, while incurring interest expense through an related person.

This Act conforms California law to the TRA of 1997 federal change as it relates to certain payments in connection with insurance.

14.

Sections **17564** and **24673.2** of the Revenue and Taxation Code are amended.

Modifications to Look-Back Method for Long-Term Contracts (IRC §460(b)).

Under the TRA of 1997, a taxpayer may elect not to apply the "look-back" method with respect to a long-term contract, if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10% of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Additionally, under the TRA of 1997, a taxpayer may elect not to reapply the "look-back" method with respect to costs incurred after completion of the long-term contract, if as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10% of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). For purposes of the "look-back"

method, the applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins, which is the day after the return due date (determined without regard to extensions) for the taxable year, and ends on such return due date for the following taxable year.

This Act conforms California law to the TRA of 1997 federal change as it relates to modification of the look-back method for long-term contracts.

15.

Sections **17570 and 24710** of the Revenue and Taxation Code are amended.

Election of Mark-to-Market for Securities and Commodities Traders (IRC §475).

Under federal and California law, a dealer in securities must compute its income pursuant to the mark-to-market method of accounting. Prior to the passage of the TRA of 1997, mark-to-market treatment did not apply to traders in securities or dealers in other property.

The TRA of 1997 allows securities traders and commodities traders and dealers to elect mark-to-market accounting treatment similar to that required for securities dealers. All securities held by an electing taxpayer in connection with a trade or business as a securities trader, and all commodities held by an electing taxpayer in connection with a trade or business as a commodities dealer or trader, are subject to mark-to-market treatment. Property not held in connection with its trade or business is not subject to the election provided that it is identified by the taxpayer under rules similar to the rules for securities dealers. An exception is provided for securities that have no connection with the taxpayer's activities as a trader and that are identified on the day acquired (or at such other times as provided in Treasury regulations). Gain or loss recognized by an electing taxpayer under the provision is ordinary gain or loss. Commodities for purposes of the provision would include only commodities of a kind customarily dealt in on an organized commodities exchange.

Similar rules apply to commodities traders. The TRA of 1997 expanded the definition of a commodity for purposes of the provision to include any commodity that is actively traded, any option, forward contract, futures contract, short position, notional principal contract or derivative instrument that references such a commodity, and any other evidence of an interest in such a commodity. Also included are positions that hedge the listed items and that are identified by the taxpayer under rules similar to the rules for securities. Congress anticipates that Treasury regulations applying IRC section 475(b)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment, will, in the case of a commodities trader or dealer, apply only to contracts and instruments referenced to commodities.

The Joint Committee on Taxation's report states that Congress did not intend that an electing taxpayer can mark-to-market loans made to customers or receivables or debt instruments acquired from customers that are not received or acquired in connection with a trade or business as a securities trader. Because Congress was concerned about issues of taxpayer selectivity, Congress intended that an electing taxpayer must be able to demonstrate by clear and convincing evidence that a security bears no relation to a taxpayer's activities as a trader in order to be identified as not subject to the mark-to-market regime. Any security that hedges another security that is held in connection with the taxpayer's trade or business

as a trader will be treated as so held. Any position that is properly subject to the mark-to-market regime will not be taken into account for purposes of the constructive sale rules of IRC section 1259.

This Act would conform California law to the TRA of 1997 federal change as it relates to mark-to-market method of accounting for securities and commodities traders.

16.

Sections **17751** of the Revenue and Taxation Code is added.

Distributions During First 65 Days of Taxable Year of Estate (IRC §646).

The TRA of 1997 extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid by the estate within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year. This provision does not allow the executor to make a separate state election.

This Act would conform California law to the TRA of 1997 federal change as it relates to the application of the 65-day rule to distributions by estates.

17.

Section **17752** of the Revenue and Taxation Code is added.

Separate Share Rules Available To Estate (IRC §663(c)).

The TRA of 1997 extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedent's will provides that all shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

This Act would conform California law to the TRA of 1997 federal change as it relates to the application of the separate share rule to estates.

18.

Section **17856** of the Revenue and Taxation Code is amended.

Repeal of Requirement Inventory be Substantially Appreciated with Respect to Disposition of Partnership Interest (IRC §§724, 725, 731, 732, 735 & 751).

The TRA of 1997 repeals the requirement that inventory be substantially appreciated in order to give rise to ordinary income in the case of sales or exchanges of partnership interests under IRC section 751(a), but not with respect to distributions under IRC section 751(b) "certain distributions treated as sales or exchanges". Thus, present law is retained with respect to distributions governed by IRC section 751(b).

This Act conforms California law to the TRA of 1997 federal change as it relates to the requirement that inventory be substantially appreciated to be considered a "hot asset".

19.

Section **17865** of the Revenue and Taxation Code is added.

This Act prevents California law from conforming to the federal "electing large partnership" provisions created by the TRA of 1997. This provision is necessary due the "date change" provision contained in this Act.

20.

Sections **18042 and 24611** of the Revenue and Taxation Code are amended.
Section **24954** is repealed and added.

Conformity to 1995 ESOPs provisions (IRC §1042).

Existing federal law provides special tax rules for the purchase of employer securities by the employees of the issuing company. These special tax rules are as follows:

- An employee stock ownership plan must be established by the employer. The employer corporation is entitled to a deduction for dividends paid to the ESOP, provided that amount is in turn paid by the ESOP to its participants or used to repay an ESOP loan. Contributions by the employer to an ESOP that are used to repay loans incurred to purchase employer stock may be deducted as long as they do not exceed 25% of the total compensation paid to participants.
- When the stock of a domestic corporate employer is closely held (that is, the corporation has no stock outstanding that is readily tradable on an established securities market), federal law allows shareholders to sell the stock to an ESOP and to roll-over the gain into other corporate stock acquired with the proceeds from the sale. Gain may be deferred in this manner so long as immediately after the sale to the ESOP, the ESOP owns at least 30% of the closely held employer's stock and within 15 months the seller purchases "qualified replacement securities" (which include stock, stock rights, bonds and debentures) in a domestic corporation. This deferral does not apply to gain includible in the gross income of any C corporation.

The state provisions that conformed to these two rules apply only to taxable and income years beginning before January 1, 1995, and on or after January 1, 1996. Therefore, there is no special treatment in current state law with respect to ESOPs for 1995.

This Act conforms state law to federal law for taxable and income year beginning in 1995, thus eliminating non-conformity for the period.

21.
Sections **18178 and 24994** of the Revenue and Taxation Code are amended.

Determination of Original Issue Discount (OID) Where Pooled Debt Obligations are Subject to Acceleration (IRC §1272(a)).

The TRA of 1997 applies the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the yield on which may be reduced by reason of prepayments. Thus, under the TRA of 1997, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. In addition, the Secretary of the Treasury is authorized to provide appropriate exemptions from the provision, including exemptions for taxpayers that hold a limited amount of debt instruments, such as small retailers.

This Act conforms California law to the TRA of 1997 federal change as it relates to determination of certain OID.

22.
Section **18505** of the Revenue and Taxation Code is amended.

Returns of Beneficiaries of Estates and Trusts (IRC §§6034A & 6048A).

Under the TRA of 1997, the beneficiaries and owners of estates or trusts (required to file returns) are required to file their returns in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

This Act conforms California law to the TRA of 1997 federal change as it relates to the consistency requirements applicable to beneficiaries of estates and trusts.

23.
Section **18572** of the Revenue and Taxation Code is amended.

This technical amendment clarifies that the disregarding of interest for 90 days for taxpayers affected by a presidentially declared disaster area only is available to individuals. The word "individual" was inserted into the section.

24.
Section **18641** of the Revenue and Taxation Code is amended.

Reporting of Certain Payments Made to Attorneys (IRC §6045(f)).

The TRA of 1997 requires gross proceeds reporting on all payments to attorneys, including professional corporations, in connection with legal services made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099B (used by brokers to report gross proceeds). In addition, payments made by a trade or business to any person, including professional corporations, for legal services must be reported on the 1099-MISC (even though previously under the Treasury regulation IRC section 1.6041-3(c) the reporting of such payments made to corporations would otherwise have been exempt). The only exception to the new reporting requirement under IRC section 6045 would be for payments reported on either Form 1099-Misc under IRC section 6041 (reports of payment of income) or on Form W-2 under IRC section 6051 (payments of wages).

This Act conforms California law to the TRA of 1997 federal change as it relates to reporting requirements of certain payments made to attorneys.

25.

Section **18645** of the Revenue and Taxation Code is amended.

Deduction for Student Loan Interest (IRC §202).

Under the TRA of 1997, certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, up to a maximum deduction of \$2,500 for the 2001 taxable year. The maximum deduction is phased in over four years, with a \$1,000 maximum deduction in 1998, \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001, and thereafter. The maximum deduction amount is not indexed for inflation. In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of \$40,000-\$55,000 (\$60,000-\$75,000 for joint returns).

The phase-out income ranges will be indexed for inflation occurring after the year 2002, rounded down to the closest multiple of \$5,000. Thus, the first taxable year for which the inflation adjustment could be made will be 2003. For purposes of the deduction, modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions), and is calculated after application of IRC section 86 (income inclusion of certain Social Security benefits), IRC section 219 (deductible IRA contributions), IRC section 469 (limitation on passive activity losses and credits), and amounts excludable from gross income under IRC section 137 (qualified adoption expenses). For purposes of sections 86, 135, 219, 469 and 137, adjusted gross income is determined without regard to the deduction for student loan interest.

Additionally, under the TRA of 1997, any person in a trade or business or any governmental agency that receives \$600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness

incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to IRC section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance as defined in IRC section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under IRC section 135, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-IRC section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under IRC section 127. It is expected that the Secretary of the Treasury will issue regulations setting forth reporting procedures to facilitate the administration of this provision. Specifically, such regulations should require lenders separately to report to borrowers the amount of interest that constitutes deductible student loan interest (i.e., interest on a qualified education loan during the first 60 months in which interest payments are required). In this regard, the regulations should include a method for borrower certification to a lender that the loan proceeds are being used to pay for qualified higher education expenses. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

This Act conforms California law to the TRA of 1997 federal change as it relates to the deduction of student loan interest.

26.

Section **19057** of the Revenue and Taxation Code is amended.

Clarification of Statute of Limitations for Pass-Through Entity Items (IRC §1284).

The TRA of 1997 clarified that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

This Act clarifies that the statute of limitations for assessing tax is four years from the date a return is filed by the "taxpayer" and does not include a return from a "person" from whom the taxpayer has received any pass-through item from. This bill would not change the treatment of items passed-through from a federally registered partnership.

27.

Section **19066.5** of the Revenue and Taxation Code is added.

Simplify Formation and Operation of International Joint Ventures (IRC §1145).

The TRA of 1997 repealed the IRC sections 1491 and 1494 excise tax and information reporting rules that applied to certain transfers of appreciated property by a U.S.

person to a foreign entity. Instead of the excise tax that applied under prior law to transfers to a foreign estate or trust, gain recognition is now required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust.

Instead of the excise tax that applied under prior federal law to certain transfers to foreign corporations, regulatory authority is granted under IRC section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not otherwise described in IRC section 367. In the case of a transfer by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise described in IRC section 367 (e.g., a capital contribution by a non-shareholder), regulatory authority is granted under IRC section 367 to treat such transfer as a sale at fair market value and to require gain recognition thereon.

Instead of the excise tax that applies under prior federal law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority is granted to deny the nonrecognition treatment that is provided under IRC section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

Gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, except as provided in regulations. This rule does not apply to a transfer to a trust to the extent that any person is treated as the owner of the trust under IRC section 679.

The TRA of 1997 clarified that, for purposes of the requirement of gain recognition upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust.

The TRA of 1997 repealed the rule that treats as U.S. source income any deemed royalty arising under IRC section 367(d). Under the TRA of 1997, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under IRC section 367(d) are treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

The TRA of 1997 also provides detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally is required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations. Failure to properly file a return will result in partners being denied their share of partnership deductions, losses, and credits.

A penalty equal to 10% of the value of the property transferred applies to a failure to comply with these reporting requirements. The penalty under present law for failure to report transfers to a foreign corporation is conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also results in gain recognition with respect to the property transferred. The penalty may not exceed \$100,000, except in cases of intentional disregard for such reporting requirements.

Under the TRA of 1997, in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates does not expire before the date that is three years after the date on which such information is provided.

This Act conforms California law to the TRA of 1997 federal change as it relates to international joint ventures as discussed above.

28.

Section **19132** of the Revenue and Taxation Code is amended.

This Act corrects a reference in the "failure to pay tax penalty" section 19132(a)(1)(E) from section 17951 (gross income of nonresidents) to section 17948 (tax on limited liability partnerships).

29.

Section **19133.5** of the Revenue and Taxation Code is amended.

Additional Exceptions for Reasonable Cause for Penalties (IRC §§6652 & 6683).

Under federal and state law, many penalties in the IRC may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Under the TRA of 1997, the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:

- (1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));
- (2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));
- (3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and
- (4) the penalty for failure to make required payments for S corporations and partnerships electing not to have the required taxable year (sec. 7519).

This Act conforms California law to the TRA of 1997 federal change by allowing a reasonable cause exception for the failure to report certain small business stock penalties.

30.

Section **19136** of the Revenue and Taxation Code is amended.

Increase Amount of Tax Exempt from Estimated Tax Requirements (IRC §6654(e)).

Under federal law, as amended by the TRA of 1997, the addition to tax for failure to make proper estimated tax payments is not imposed where the total tax liability for the year, reduced by any withheld tax, is less than \$1,000, rather than the pre-TRA of 97 amount of \$500.

This Act increased the tax exempt from estimated tax requirements for state purposes from \$100 to \$200 (\$50 to \$100 for married filing separate taxpayers).

Additionally, **this Act** provides that an estimated tax penalty will not apply to the 1998 taxable year if the reason the underpayment was created or increased was due to the rollover of an ordinary IRA into a Roth IRA.

31.

Section **19136.6** of the Revenue and Taxation Code is amended.

This Act provides that a failure to pay an estimated tax penalty will not apply to the 1999 taxable or income year if the reason the underpayment was created or increased was due to a provision in this Act.

32.

Section **19141.2** of the Revenue and Taxation Code is amended.

Controlled Foreign Partnerships Subject to Information Reporting (IRC §6038)

Under the TRA of 1997, reporting rules similar to those applicable under present law in the case of controlled foreign corporations apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner is considered to control a foreign partnership if the partner holds a more than 50% interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership.

Similar information reporting also will be required from a U.S. 10% partner of a foreign partnership that is controlled by U.S. 10% partners. A \$10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to \$50,000 apply in the case of continued noncompliance after notification by the Secretary of the Treasury.

The penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties. Under the TRA of 1997, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10% interest. A \$10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to \$50,000 apply in the case of continued noncompliance after notification by the Secretary. The penalties for failure to report information with respect to a foreign corporation are conformed with these penalties.

For purposes of the information reporting rules applicable to a U.S. partner that controls a foreign partnership, the TRA of 1997 clarifies that a partner's interest in a partnership is determined with application of constructive ownership rules similar to those provided in IRC section 267(c) (other than paragraph (3)).

This Act conforms to the information reporting penalties discussed above except that \$1,000 and \$24,000 amounts replace the federal amounts of \$10,000 and \$50,000, respectively.

33.

Section **19141.5** of the Revenue and Taxation Code is amended.

Transfers of Property to Foreign Partnerships Subject to Information Reporting (IRC §6038B)

Under the TRA of 1997, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations apply in the case of transfers to foreign partnerships. These reporting rules apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10% interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded \$100,000.

This Act conforms to federal reporting requirements in the case of transfers to a foreign partnerships. The Act further provides that the information required to be filed with the Franchise Tax Board shall be a copy of the information required to be provided to the Internal Revenue Service. The Act did not conform to the federal penalty.

34.

Section **19182** of the Revenue and Taxation Code is amended.

Registration and Penalties For Confidential Corporate Tax Shelters (IRC §6662(d)).

Accuracy-Related Penalty - Under the TRA of 1997, a promoter of a corporate tax shelter must register the shelter with the Secretary of the Treasury. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential investors. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

Under the TRA of 1997, a corporate tax shelter includes any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of \$100,000. A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. For this purpose, the "promoter" includes specified related parties.

Registration requires the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of IRC section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of \$10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50% penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50% penalty to 75% of the applicable fees.

Substantial Understatement Penalty - In determining whether a substantial understatement exists, the TRA of 1997 amendment provides that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax shelter as defined under the modification described below or under present law. Additionally the TRA of 1997 amendments, for purposes of the special rules to determine whether there is a significant underpayment by a tax shelter, changes the definition of a tax shelter to be consistent with the registration provisions for tax shelters so that it is an entity the significant purpose (rather than principal purpose) of which is the avoidance or evasion of federal income tax.

Treasury Report - The Treasury Department is directed, in consultation with the Department of Justice, to issue a report no later than August 5, 1998, to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under IRC section 7408 (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (regardless of whether directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation.

This Act conforms California law to the TRA of 1997 federal change as it relates to the registration and penalties for confidential corporate tax shelters. The requirements for registration are deemed complied with if the taxpayer complies with federal law.

35.

Section 19184 of the Revenue and Taxation Code is amended.

This Act adds reporting requirements under qualified state tuition programs to the failure to report certain information penalty of \$50.

36.

Section **19521** of the Revenue and Taxation Code is amended.

Certain Notices Disregarded Under Provision Increasing Interest Rate on Large Corporate Underpayments (IRC §6621(c)).

Under the TRA of 1997, for purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than \$100,000 (determined by not taking into account any interest, penalties, or additions to tax).

This Act conforms California law to the TRA of 1997 federal change as it relates to increasing the interest rate on large corporate underpayments.

37.

Section **19524** of the Revenue and Taxation Code is amended.

This Act does not conform to the TRA of 1997 (IRC §6011(e)(2)) requirement that partnerships having more than 100 partners file their returns on magnetic media. This provision provides an exception to the IRC.

38.

Section **19721.6** of the Revenue and Taxation Code is amended.

This Act corrects a transposition error in the code section number. Section 19721.6 is corrected to read section **19271.6**.

39.

Sections **20514, 20543 and 20544** of the Revenue and Taxation Code are amended.

Homeowners and Renters Assistance Program (HRA).

This Act requires that all income levels eligible for assistance under prior law be multiplied by 2.51 for assistance provided for the 1999 calendar year, making the maximum total household income eligible for assistance \$33,132 (increased from \$13,200). The 2.51 multiplier represents the increase in inflation since 1977 (less a minor augmentation that occurred to the HRA Program in 1989). These provisions also would require annual inflation adjustments, based upon changes in the Consumer Price Index (CPI).

This Act requires the California Department of Industrial Relations (DIR) to transmit to the FTB on or before February 1 of each year the percentage change in the California CPI for all items from June of the second preceding calendar year to June of the immediately preceding calendar year.

This Act applies inflation adjustment factors to both the gross household income limit and the total household income limit of the HRA program. The inflation adjustment would be based upon the percentage change in the California CPI for all items.

40.

Section **23455.5** of the Revenue and Taxation Code is added.

This Act provides an exception to IRC §55(e) exemption for small corporations from alternative minimum tax. The TRA of 1997 repealed alternative minimum tax for small business corporations with average gross receipts for the three year period beginning after 1994 of less than \$5 million. This provision provides that California does not conform to the federal small corporation exception.

41.

Section **23456** of the Revenue and Taxation Code is amended.

Modification to Minimum Tax Depreciation Rules (IRC §56(g)(4)(A)).

The federal Revenue Reconciliation Act of 1993 eliminated the depreciation component of the ACE adjustment for corporations. Thus generally, in conjunction with the TRA of 1997 amendment to the ACE adjustment (see item b. on page 2), depreciation is no longer an adjustment or preference item for AMT purposes.

Prior to **this Act**, California required the depreciation component of the ACE adjustment computed. This Act conformed California law to the Revenue Reconciliation Act of 1993 elimination of the depreciation component of the ACE adjustment. Therefore, California is in conformity with the Revenue Reconciliation Act of 1993 elimination of the depreciation component of the ACE.

42.

Section **23701** of the Revenue and Taxation Code is amended.

Timeshare Associations (IRC §528).

The TRA of 1997 amended IRC section 528 to permit timeshare associations to qualify for taxation under that IRC section. Timeshare associations will have to meet the requirements of IRC section 528 (e.g., the 60% gross income, 90% expenditure, and the non-profit organizational and operational requirements). Timeshare associations electing to be taxed under IRC section 528 are subject to a tax on their timeshare association income at a rate of 32%.

60-Percent Test - A qualified timeshare association must receive at least 60% of its income from membership dues, fees and assessments from owners of either (a) timeshare rights to use of, or (b) timeshare ownership in, the timeshare association property.

90-Percent Test - At least 90% of the expenditures of the timeshare association must be for the acquisition, management, maintenance, or care of association property, and activities provided by the association to, or on behalf of, members of the timeshare association. Activities provided to or on behalf of members of the timeshare association includes events located on association property (e.g., member's meetings at the association's meeting room, parties at the association's swimming pool, golf lessons on association's golf range, transportation to and from association property, etc.).

Organizational and Operational Tests - The TRA of 1997 provided that association property includes property in which a timeshare association or members of the association have rights arising out of recorded easements, covenants, and other recorded instruments to use property related to the timeshare project. No part of

the net earnings of the timeshare association can inure to the benefit (other than by acquiring, constructing, or providing management, maintenance, and care of property of the timeshare association or rebate of excess membership dues, fees, or assessments) of any private shareholder or individual. A member of a qualified timeshare association must hold a timeshare right to use (or timeshare ownership in) real property of the association. A qualified timeshare association cannot be a condominium management association. The timeshare association must elect to be taxed under IRC section 528.

This Act conforms California law to the TRA of 1997 federal change as it relates to taxation of timeshare associations. Timeshare associations would be subject to tax on its "timeshare association taxable income" at the corporate income tax rates.

43.

Section **23704** of the Revenue and Taxation Code is amended.

Purchasing of Receivables by Tax-Exempt Hospital Cooperative Organizations (IRC §501(e)).

The TRA of 1997 clarified that, for purposes of IRC section 501(e), billing and collection services include the purchase of patron accounts receivable on a recourse basis. Thus, hospital cooperative service organizations are permitted to advance cash on the basis of member accounts receivable, provided that each member hospital retains the risk of non-payment with respect to its accounts receivable. No inference is intended with respect to taxable years prior to the effective date of this change.

This Act conforms California law to the TRA of 1997 federal change as it relates to the purchase by hospital cooperatives of certain accounts receivable.

44.

Section **23704.3** of the Revenue and Taxation Code is added.

Hospitals Participating in Provider-Sponsored Organizations (IRC §501(o)).

The Balanced Budget Act of 1997 (BBA of 1997), provided that an organization does not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of IRC section 501(c)(3) solely because a hospital which is owned and operated by such organization participates in a provider-sponsored organization (PSO) (as defined in IRC section 1845(a)(1) of the Social Security Act), regardless of whether such PSO is exempt from tax. Thus, participation by a hospital in a PSO (whether taxable or tax-exempt) is deemed to satisfy that the venture and the participation of the tax-exempt organization therein furthers a charitable purpose. The qualification of a hospital as a tax-exempt charitable organization under IRC section 501(c)(3) is determined as under present law.

The BBA of 1997 did not change the restrictions on private inurement and private benefit. However, the provision provides that any person with a material financial interest in such a PSO shall be treated as a private shareholder or individual with respect to the hospital for purposes of applying the private inurement prohibition in Code section 501(c)(3). Accordingly, the facts and circumstances of each PSO arrangement are evaluated to determine whether the arrangement entails impermissible private inurement or more than incidental private benefit (e.g., where there is a disproportionate allocation of profits and losses to the non-

exempt partners, the tax-exempt partner makes loans to the joint venture that are commercially unreasonable, the tax-exempt partner provides property or services to the joint venture at less than fair market value, or a non-exempt partner receives more than reasonable compensation for the sale of property or services to the joint venture).

The BBA of 1997 did not change the restrictions on lobbying and political activities. In addition, the restrictions on the provision of commercial-type insurance continue to apply.

This Act conforms California law to the federal change made by the BBA of 1997. An organization does not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of B&CTL section 23701(d) solely because a hospital which is owned and operated by such organization participates in a PSO regardless of whether such PSO is exempt from tax.

45.

Section **23771** of the Revenue and Taxation Code is amended.

This Act changes the filing due date for education IRAs from four and one half months to three and one half months after the close of the income year to match the federal due date.

46.

Section **23800.5** of the Revenue and Taxation Code is amended.

This Act corrects an incorrect cross reference in §23800.5(c) from IRC §1361(c)(7) to IRC §1361(c)(6).

47.

Section **23801** of the Revenue and Taxation Code is amended.

For income years beginning on or after January 1, 1987, (the first year California allowed "S" status), **this Act** allows corporations who did not file a timely federal election to be an S corporation to be treated as an S corporation for state purposes if:

- The corporation and all its shareholders reported their income for California tax purposes on their original returns consistent with S corporation status for the year the election should have been made and all subsequent years.
- The corporation has received notice from the Internal Revenue Service stating that relief was granted under the untimely election provisions under IRC §1362(f).

48.

Section **23806** of the Revenue and Taxation Code is amended.

For certain stock purchases or asset acquisitions occurring in 1997 and within an income year beginning in 1997, **this Act** permits a corporation making a federal asset acquisitions election under IRC §338 to not be bound to the election for state purposes. For income years beginning on or after January 1, 1998, **this Act** requires the S corporation and its shareholders to report certain stock purchases

or asset acquisitions for state purposes as reported for federal purposes. There is no longer a federal/state difference in regards to making an asset acquisition election.

49.
Sections **24309.5** and **24349** of the Revenue and Taxation Code are amended.

Treatment of Construction Allowance Provided to Lessee (IRC §§110, 168(i) & 6724).

A coordinated issue paper issued by the Internal Revenue Service (IRS) on October 7, 1996, states the IRS position that construction allowances should generally be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of several factors.

The TRA of 1997 codified the treatment recognized in the federal coordinated issue paper. Additionally, however, it provides a safe harbor by providing that (1) a lessee's gross income would not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space; and (2) the lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor for depreciation.

The exclusion only applies to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. Reporting requirements are provided to ensure that both the lessor and lessee treat such amounts in accordance with the provision. Under regulations, the lessor and the lessee shall, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provision.

This Act conforms California law to the TRA of 1997 federal change as it relates to construction allowance provided to lessees.

50.
Section **24355.4** of the Revenue and Taxation Code is amended.

Limitation on Property for which Income Forecast Method May be Used
(IRC §§167(g)& 168).

The TRA of 1997 clarifies the types of property to which the income forecast method may be applied. The income forecast method is available to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. The mere fact that the property is subject to a lease should not make the property eligible for the income forecast method. The income forecast method is not to be applicable to property to which IRC section 197 applies.

In addition under the TRA of 1997, consumer durables subject to rent-to-own

contracts are provided a three-year recovery period and a four-year class life for MACRS purposes (and are not eligible for the income forecast method). Such property generally is described in Rev. Proc. 95-38. In addition, the special three-year recovery period may apply to any property generally used in the home for personal, but not business, use. The committee reports indicate that Congress understands that certain rent-to-own property, including computer and peripheral equipment, may be used in the home for either personal or business purposes, and the taxpayer may not be aware of how its customers may use the property. So as not to increase the administrative burdens taxpayers, the conferees intend that if such dual-use property does not represent a significant portion of a taxpayer's leasing property and if such other leasing property predominantly is qualified rent-to-own property, then such dual-use property generally also would be qualified rent-to-own property. However, if such dual-use property represents a significant portion of the taxpayer's leasing property, the burden of proof is placed on the taxpayer to show that such property is qualified rent-to-own property. In addition, the TRA of 1997 modifies the definition of "rent-to-own contract" to include leases that provide for decreasing regular periodic payments.

Finally, the TRA of 1997 clarifies that the three-year recovery period provided under the provision only applies to property subject to leases, and the committee reports indicate that no inference is intended as to whether any arrangement constitutes a lease for tax purposes.

This Act conforms the PITL and B&CTL to the TRA of 1997 federal change as it relates to use of the income forecast method of depreciation. Under the B&CTL, this Act creates a special class life of four years for certain "rent-to-own property."

51.

Section **24357.7** of the Revenue and Taxation Code is amended.

This Act made non-substantive technical changes by renumbering part of the section to the proper format and removed the word "such" and replace it with "that".

52.

Section **24357.8** of the Revenue and Taxation Code is amended.

This Act made non-substantive technical changes by removing "of 1954" from the phrase "Internal Revenue Code of 1954".

53.

Section **24357.9** of the Revenue and Taxation Code is added.

Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment (IRC §170(e)(6)).

The TRA of 1997 expanded the list of qualified contributions that qualify for the augmented deduction under IRC section 170(e). Under the TRA of 1997, qualified contributions mean gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any of grades K through 12. This provision is effective for contributions made in taxable years beginning after December 31, 1997, and before January 1, 2001.

Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) charitable or educational entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the TRA of 1997 clarifies that the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The TRA of 1997 permits payment by the donee organization of shipping, transfer, and installation costs. The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

In the case of contributions made through private foundations, the TRA of 1997 permits the payment by the private foundation of shipping, transfer, and installation costs.

This Act conforms California law to the TRA of 1997 federal change in the augmented deduction for computer technology and equipment to be used within California for educational purposes in any of grades K through 12. This Act does not conform to the augmented deduction of corporate contributions of inventory property for the care of the ill, the needy, or infants, and certain corporate contributions of scientific equipment.

54.

Section **24402** of the Revenue and Taxation Code is amended.

Modify Holding Period for Dividends-Received Deduction (IRC §246(c)).

Under prior federal and current state law, the dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46 or 91 day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

The TRA of 1997 provides that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period (generally, 46-day for common and 91-day for preferred) for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

This Act conforms California law to the TRA of 1997 federal change as it relates to holding period for the dividends-received deduction.

55.

Section **24416** of the Revenue and Taxation Code is amended.

The Act replaced a reference to the prior federal carry forward period of "net operating losses" of 15 years with the present federal carry forward period of 20 years.

56.

Section **24954.1** of the Revenue and Taxation Code is added.

This Act prevents California law from conforming to the federal IRC §1042(g) the nonrecognition of gain relating to the sales of stock in agricultural refiners and processors provision created by the TRA of 1997. This provision is necessary due the "date change" provision contained in this Act.

57.

Various provisions of the TRA of 1997 were conformed to with and without exceptions prior to this Act. Because the "specified date" prior to this Act was January 1, 1997, conformity to the various TRA of 1997 provisions was accomplished through stand alone language (which mirrored the federal language). Because of the specified date change to January 1, 1998, prior stand alone language amendments to conform to portions of the TRA of 1997 are no longer necessary.

This Act adds, amends or repeals the following sections to remove, make inoperative or to clarify unnecessary sections or language which conforms to portions of the TRA of 1997 by reference.

Section #	Action	Topic
17085.8	Repealed	IRA Penalty
17088.5	Amended	Regulated Investment Companies (RIC)
17088.6	Amended	Real Estate Investment Trust (REIT)
17132.6	Amended	Survivor Benefits for Safety Officers
17152	Amended	Sale of Residence
17210.6	Repealed	Roth IRA
17507.4	Amended	IRAs
17507.6	Amended	Roth IRAs
17559	Amended	Sale of Livestock
17760.5	Amended	Funeral Trusts
18037.6	Repealed	Sale of Residence
18038.3	Amended	Sale of Livestock
18038.4	Added	Rollover of Business Stock
18572	Amended	Sale of Residence
23712	Amended	Education IRA
24652.5	Amended	Family Farming Suspense Accounts
24661.5	Amended	Sale of Livestock
24871.5	Amended	RICs
24872.4	Amended	REITs
24872.5	Amended	REITs
24872.7	Amended	REITs
24875.5	Amended	FASITs
24949.1	Amended	Sale of Livestock

This act will not require any reports by the department to the Legislature.